

3/11/87

SB 259
Montford
(T. Smith)

SUBJECT: Lending rate and investment of TWDB bonds

COMMITTEE: Natural Resources: favorable, without amendment

VOTE: 7 ayes--T. Smith, J. Harris, C. Johnson, Holzheauzer,
Russell, Shelley, Yost

0 nays

2 absent--Hammond, Toomey

SENATE VOTE: On third reading, Feb. 16--29 ayes, 0 nays

WITNESSES: For--Steve Stagner, Texas Water Alliance

Against--None

On--Reg Arnold and Jerry Turner, Texas Water
Development Board

BACKGROUND: The Texas Water Development Board (TWDB) can
issue general-obligation bonds to finance water
development projects. The TWDB uses the bond proceeds
to purchase bonds and securities backed by the
political subdivision proposing the water project. The
political subdivision is responsible for paying the
principal and interest to the TWDB.

Current law requires that the TWDB's investment in
local bonds bear interest at the "lending rate." The
"lending rate" is set by a statutory formula. It is
calculated by adding one-half percent to the weighted
average of the cost of uncommitted funds from the last
sale of TWDB bonds.

The law requires that proceeds from the sale of TWDB
bonds that are not needed for at least 90 days be
invested in direct obligations of the United States or
in other obligations unconditionally guaranteed by the
United States. The money realized from these
short-term investments -- the difference between a
bond's cost and its earnings -- constitutes "arbitrage
profits." However, the federal Tax Reform Act of 1986
now bars arbitrage profits, with the exception of those
realized from investment in municipal bonds. Any
arbitrage profits made with tax-exempt bond proceeds,

except for this one exception, must be returned to the U.S. Treasury.

DIGEST:

SB 259 would eliminate the statutory formula for calculating the "lending rate" at which political subdivisions must reimburse the TWDB. The bill would allow the TWDB to establish the "lending rate" by rule.

The bill also would allow the TWDB to invest unused proceeds from the sale of TWDB bonds in State of Texas bonds and municipal bonds.

SUPPORTERS
SAY:

The statutory formula used to calculate the bond interest charged to political subdivisions is very inflexible and has made it difficult for the TWDB to remain competitive in a market characterized by volatile interest rates. In some situations the TWDB has been unable to make loans for water projects because the interest rate it is required to charge political subdivisions is much higher than the interest rates charged in the marketplace. The TWDB should be allowed to set its own lending rate by rule so that it can periodically adjust the rate in response to market conditions.

The TWDB needs the ability to set its own lending rate so it can work out a mutually acceptable debt-service schedule with the political subdivision desiring to finance a water project. For example, under present constraints the TWDB is typically limited to a 20-year bond maturity schedule. The ability to set a flexible lending rate would allow the TWDB to structure 15-year or 30-year bond maturity schedules, depending on the needs of the political subdivision. Such flexibility is especially important to facilitate the TWDB's ability to fund large projects, which always require some special financing arrangement.

In the past, the TWDB has been forced to draw on general revenues in funding large, long-term projects, because such projects do not generate income for a significant period of time. A flexible lending rate would solve this problem by allowing the TWDB to work out the special financing arrangements that are necessary to fit a specific project.

The bill is also needed because of the new arbitrage restrictions of the Tax Reform Act of 1986. Arbitrage profits from the investment of idle bond proceeds now must be returned to the federal government, unless the

proceeds are invested in municipal bonds. By allowing the TWDB to invest in municipal bonds, SB 259 would keep in Texas any arbitrage profit that might be made.

OPPONENTS
SAY:

SB 259 should include a minimum interest-rate level for TWDB loans to political subdivisions. The current statutory formula was designed to assure that the TWDB got back all the money that it was loaning out, plus a little extra. Giving the TWDB the unrestrained flexibility to set its own lending rate could get the state into trouble. If the TWDB lends money at a cheaper rate than it paid for it, it runs the risk of a deficit that would have to be covered with general revenues.

By allowing the TWDB to join the interest-rate competition in commercial markets, the bill would give the board an incentive to undercut the interest rates offered by others, along with the attendant risk of an inadequate return on investment. An overly flexible interest rate would remove the guarantee that the TWDB will get back all of the money that it loaned out.